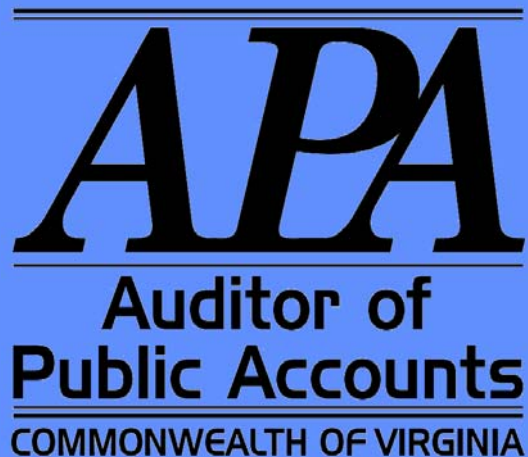


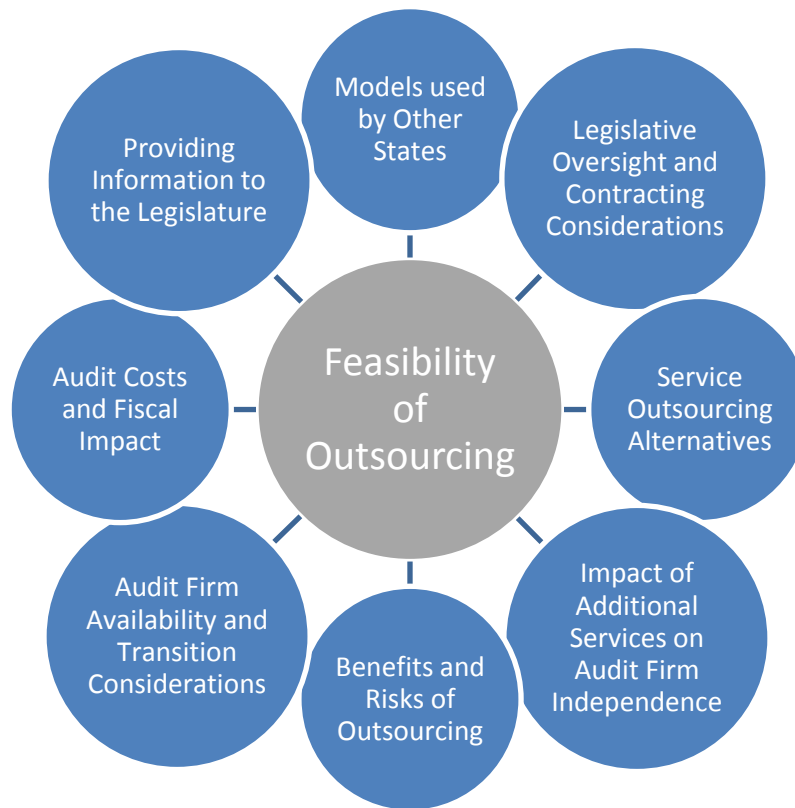
STUDY ON FEASIBILITY OF USING CPA FIRMS

DECEMBER 2012



Executive Summary

In the 2012 Session of the General Assembly, House Bill 341 proposed that the Auditor of Public Accounts (APA) procure the services of auditing firms to carry out the duties the APA currently performs. The Chairman of the General Government Subcommittee of the House Appropriations Committee requested, with the concurrence of the Bill's patron, that the APA review certain issues surrounding the feasibility of moving forward with the proposal, consult with public stakeholders, and report back to the General Government Subcommittee prior to the beginning of the 2013 session of the General Assembly. In this report, we provide an overview of the existing model as well as the work the APA currently performs and information on the extent of outsourcing in other states and address the issues in the request letter as reflected below.



Throughout the report we provide *decision considerations* and related *decision points* for the General Assembly to address when evaluating the different options associated with audit outsourcing. The General Assembly's initial decisions regarding the degree of legislative oversight and the nature and extent of services will impact which *decision points* it must address.

Prior to addressing the *decision points* we have outlined in this report, the General Assembly should consider determining what its overall objective is for using auditing firms instead of the APA to perform audits. Having the objective in mind would help to provide a context for considering the various *decision points*, as some may not be relevant, depending on the objective. Due to interdependencies between the various *decisions points*, the General Assembly should not attempt to address them singularly; but should consider each in relation to the other *decision points*.

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Introduction

In the 2012 Session of the General Assembly, House Bill 341 proposed that the Auditor of Public Accounts (APA) procure the services of auditing firms to carry out the duty to audit the accounts of state agencies and institutions, or other agency handling any state funds, subject to the provision that the cost should not exceed funds available in the appropriation for the conduct of the office. The Chairman of the General Government Subcommittee of the House Appropriations Committee requested, with the concurrence of the Bill's patron, that the APA review certain issues surrounding the proposal, consult with public stakeholders, and report back to the General Government Subcommittee prior to the beginning of the 2013 session of the General Assembly.

Exhibit 1 contains a copy of the letter we received requesting we conduct a study of the feasibility of moving forward with the proposal. Below we summarize the issues the request letter addresses.

- Should the Legislature retain oversight over the audit function?
- What audits could an audit firm perform and what auditing standards should firms follow when performing this work?
- What are the benefits and risk to the Executive branch when working with an audit firm?
- Due to deadlines associated with some of the audits, are there firms with sufficient staff available to perform the work within required timeframes? Should the Commonwealth consider a transition period to ensure firms have sufficient staff?
- What is the extent of outsourcing in other states and the associated costs?
- How could audit firms recover the costs of information requested by the legislature beyond the audit service?
- Can audit firms provide other services to the Commonwealth's agencies and institutions beyond the audit contract?
- What is the fiscal impact to the APA of making this change?

In this report, we will first provide an overview of the work the APA currently performs and then provide information on the extent of outsourcing in other states. We will use this information to address the issues in the request letter.

Throughout the report we provide *decision considerations* and related *decision points* for the General Assembly to address when evaluating the different options associated with audit outsourcing. The General Assembly's initial decisions regarding the degree of legislative oversight and the nature and extent of services will impact which *decision points* it must address. In addition, there are interdependencies between the various *decision points* that the General Assembly must consider when making decisions regarding outsourcing. Appendix A provides a crosswalk between the requested information, the sections of the report and the various *decision points*.

Legislative Oversight

The concept of accountability for the use of public resources is a cornerstone of the governing process. The Constitution of Virginia establishes the Auditor of Public Accounts to assist the legislature in its fiscal oversight by providing for the audit of substantially all agencies and institutions handling state funds. Thus, from the very beginning, the audit function was part of legislative oversight and has been constitutionally expanded by having the APA involved with the Revenue Stabilization Fund and the issuance of debt.

Auditor independence is key to ensuring that the public will view audit results as impartial. Legislative responsibility for the audit function ensures the APA's independence from the Executive and Judicial branches. The auditor provides the legislature with independent, unbiased information on how the agencies and institutions are safeguarding and using public funds, which give an initial measure of their effectiveness.

Other entities responsible for auditing in the Commonwealth include the Joint Legislative Audit and Review Commission (JLARC), internal audit, and the Office of the Inspector General. JLARC is one of the oversight agencies of the Virginia General Assembly, established to evaluate the operations and performance of the state agencies and programs it creates. Most institutions of higher education and over 20 other agencies have internal audit functions that have the oversight board or senior management approve the auditor's work plan. The state recently created an Office of the Inspector General. The Inspector General has responsibility for the state's fraud hotline, oversight of internal audit, and performance reviews of state agencies evaluating effectiveness of programs.

APA Overview

We begin our report by first providing an overview of the nature of work the APA performs and the cost of the services we provide to determine the volume of work subject to potential outsourcing to audit firms. Below is a summary of the operating expenses, staffing levels, and number of audit reports APA issued for the last five years.

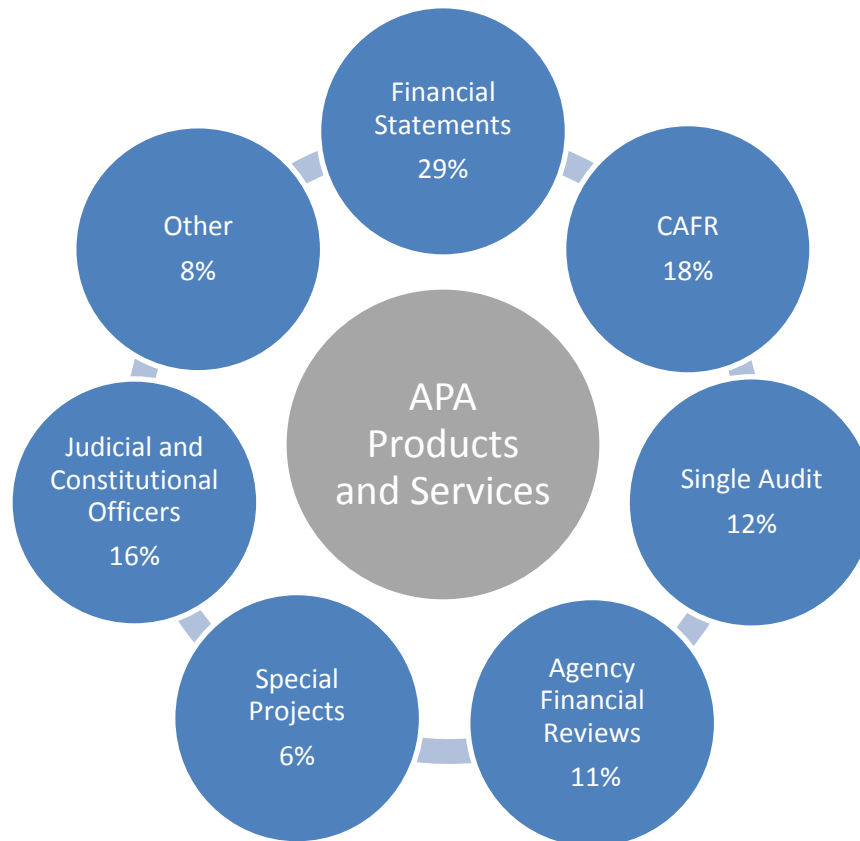
Year	Operating Expenses*	Staff Level	Number of Audit Reports Issued**
2008	\$10,544,480	129	494
2009	\$10,771,666	121	524
2010	\$9,756,820	111	591
2011	\$9,638,316	103	568
2012	\$9,766,182	107	582

Source: APA Annual Reports 2008 through 2012 and distribution records

*Contains all expenses for the office, including direct and indirect costs

**Includes letter reports

The chart below illustrates the variety of audits and other activities the APA performs throughout the year. APA must follow various nationally recognized auditing standards when performing our audits, so that our audits achieve the appropriate objectives depending on the work product.



For the Commonwealth's Comprehensive Annual Financial Report (CAFR), other financial statement audits, and audits of federal programs for the Single Audit, we follow Government Auditing Standards and American Institute of Certified Public Accountants (AICPA) auditing standards. For agency financial reviews and special projects, we follow performance audit standards under Government Auditing Standards. For our reviews of judicial and constitutional officer activities we follow internally developed policies and procedures only. For our other remaining activities, including the Comparative Report and Commonwealth Data Point, we follow internally developed policies and procedures and we also perform agreed-upon procedures under the AICPA attestation standards.

CAFR, Single Audit and Financial Statement Audits

The Commonwealth's CAFR is an audit of the state-wide financial statements used by bond rating agencies and others to assess the fiscal health of the Commonwealth. The CAFR audit and other financial statement audits (which include colleges and universities, enterprise funds, trust funds and other stand-alone audits) comprise approximately 47 percent of the APA's work load. The Code of Virginia mandates the completion of the CAFR audit by December 15 each year and as a result

much of this financial statement audit work is part of meeting the statutory deadline. The APA performs most other stand-alone agency audits as a result of Code of Virginia mandates, bond requirements or accreditation purposes.

The APA also performs the Statewide Single Audit of federal funds. We perform some of this work along with the audits of the financial statements and agencies material to the CAFR, and perform additional work at other agencies (approximately 12 percent of our work load). We complete this work in time to issue the single audit report within 60 days of the completion of the CAFR, as the report serves to communicate not only the single audit findings but also the internal control and compliance matters related to the CAFR audit. This is usually 45 days ahead of the current federally mandated March 31 single audit report deadline.

Agency Financial Reviews

Some agencies and institutions included in the CAFR but do not need to have the audit completed by the CAFR deadline. For these agencies we ensure they are accurately reporting their financial activity in the Commonwealth's accounting system, ensure they have sufficient internal controls surrounding the financial activity, and determine if they are complying with laws and regulations. We follow performance audit standards under Government Auditing Standards for these reviews. We select agencies for audit based on a variety of factors including risk and date of last audit and at a minimum audit each agency at least once every three years. These audits represent 11 percent of our work load.

Special Projects

We annually prepare an analysis of risk in the Commonwealth and based on this analysis the APA selects areas for special projects (approximately six percent of our work load), usually completed under performance audit standards. These special projects allow for the examination of issues on a statewide basis, such as reviews of small purchase charge cards or deferred maintenance of capital assets, and also monitoring of new systems during their implementation, such as the Cardinal (the Commonwealth's new financial accounting system) and the VRS Modernization projects to alert the legislature and others of potential problems before the Commonwealth incurs excessive cost or a non-working system. We also perform special projects requested by the legislature such as our annual review of the Commonwealth's Performance Measures.

Decision Consideration

Financial statement audits of the CAFR and agencies and institutions, **agency financial reviews** and **special projects** provide the Commonwealth and the General Assembly with a staff who have a working knowledge and contact with the agencies and institutions spending the Commonwealth's resources. The General Assembly and the legislative staff have used the knowledge acquired by our staff to examine unusual agency and institutional financial activity, determine the impact of statutory changes, and request studies of broader issues.

Additionally, the APA have used their working knowledge of the agencies and institutions' operations, including internal controls and processes, to alert the legislature to the impact of changes

in accounting and auditing requirements and their impact on the Commonwealth's bond ratings and the Commonwealth's budget. We have also used this knowledge in special projects to prevent Information Technology projects from failing and to recommend operational efficiencies to reduce funding requirements in the Commonwealth's budget.

If the APA no longer performs audits, we would start to lose the depth of knowledge of the agencies to readily identify risks and make informed decisions about areas requiring further review. We would also not have the level of expertise to advise the General Assembly on the impacts of changes in accounting and auditing practices and their effect on the Commonwealth's bond rating and budget. The nature and degree of audits outsourced would determine the extent of the loss of knowledge.

Decision Point 1

What extent of internal expertise does the General Assembly want to have available to advise them of financial risk areas at agencies and on accounting and auditing requirements and the impact of these requirements on the Commonwealth?

Judicial and Constitutional Officers

Using internally developed policies and procedures, the APA audits the records at the circuit and district courts, other constitutional officers and general receivers (approximately 16 percent of the work load) and reports the results in letters to the judges and other local officials. For the district court audits, we centrally determine the extent of the audit work for the on-site visits with emphasis on exception testing using the Supreme Court financial and case management system.

Other Activities

The APA performs agreed-upon procedures for the individual games Lottery participates in with other states, the universities' National Collegiate Athletics' Association activities, and the Comptroller's preliminary report on the general fund of the Commonwealth. This work only comprises approximately two percent of our work load, but must follow national standards and has deadlines, which the Commonwealth must meet. Generally, we perform the NCAA procedures at the time we audit the financial statements of the university, to avoid duplication of efforts in gaining an understanding of the internal control processes. The same relationship holds true for the Lottery games and the Lottery audit, as well as, the preliminary report on the general fund and the CAFR audit.

There are also several Code of Virginia or Appropriation Act mandated projects that we perform annually, including the calculations for the Revenue Stabilization Fund, the local fines and fees reversion calculation and the Comparative Report of Local Government (approximately three percent of our work load). The Comparative Report is a compilation of information provided by each locality in the Commonwealth and standards are not applicable. Accounting and Auditing Standards are also not applicable for the calculations for the Revenue Stabilization Fund or for the local fines and fees reversion.

Further, the APA maintains Commonwealth Data Point (approximately two percent) and performs an analysis of the actual results at all executive branch agencies as compared to their budgets (one percent). For Commonwealth Data Point, we obtain data from all state agencies and institutions and make it available electronically. The APA performs this work in conjunction with obtaining the data for its audits.

The analysis we perform of the budget does not result in a report; however, we use the information in planning the audit work at the individual agencies. We have found it to be more effective for a small group of individuals that specialize in this area to perform this work rather than have the auditors on each audit perform it as part of the project.

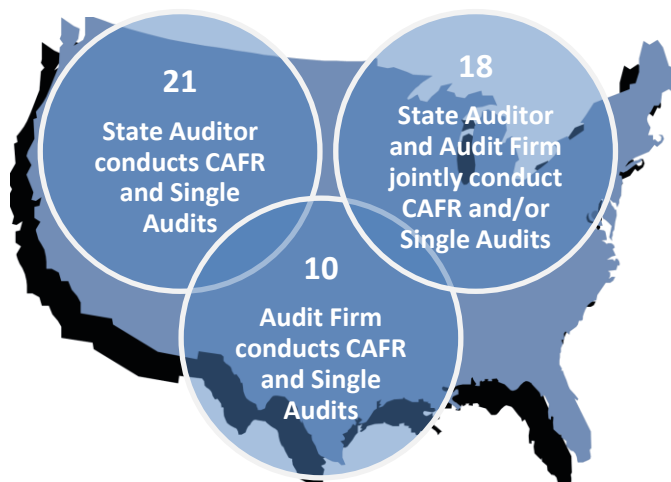
Another non-audit function provided is oversight of the certified public accounting firms that audit local governments in the Commonwealth. The APA establishes guidelines, or specifications, that the firms must follow when auditing local governments. The specifications assist state agencies in making sure that the auditing firms understand and include audit test work of state grants and contracts as well as detail how auditors should perform audit work unique to Virginia local governments.

The APA is not responsible for procuring the auditing firm or overseeing their work during the process. However, annually, the APA selects a sample of the firms and conducts a post issuance quality control review to ensure the firms' work complies with auditing standards and encompasses all of the requirements of the federal government, if the local government receives federal funds, and the APA's specifications. This review is in addition to the peer reviews that audit firms must periodically undergo.

Finally, in accordance with the Code of Virginia, during the year we receive reports of alleged fraudulent transactions. We conduct an initial review of all reports and, depending on the nature and circumstances, determine how best to proceed. The majority of reports and related situations result in the APA and State Police coordinating our activities with the agency, institution and locality officials, primarily internal auditors, and local law enforcement.

Models Used by Other States

To determine the extent of work outside auditing firms perform for other state governments, we started with the "Auditing in the States" survey the National Association of State Auditors, Comptrollers and Treasurers (NASACT) conducts annually exploring operations and activities of the various State Auditors' offices in the United States. Only one state, Rhode Island, did not respond to the survey. Of the 49 State Auditors responding, the legislature or an oversight group appoints 31 and 18 stand



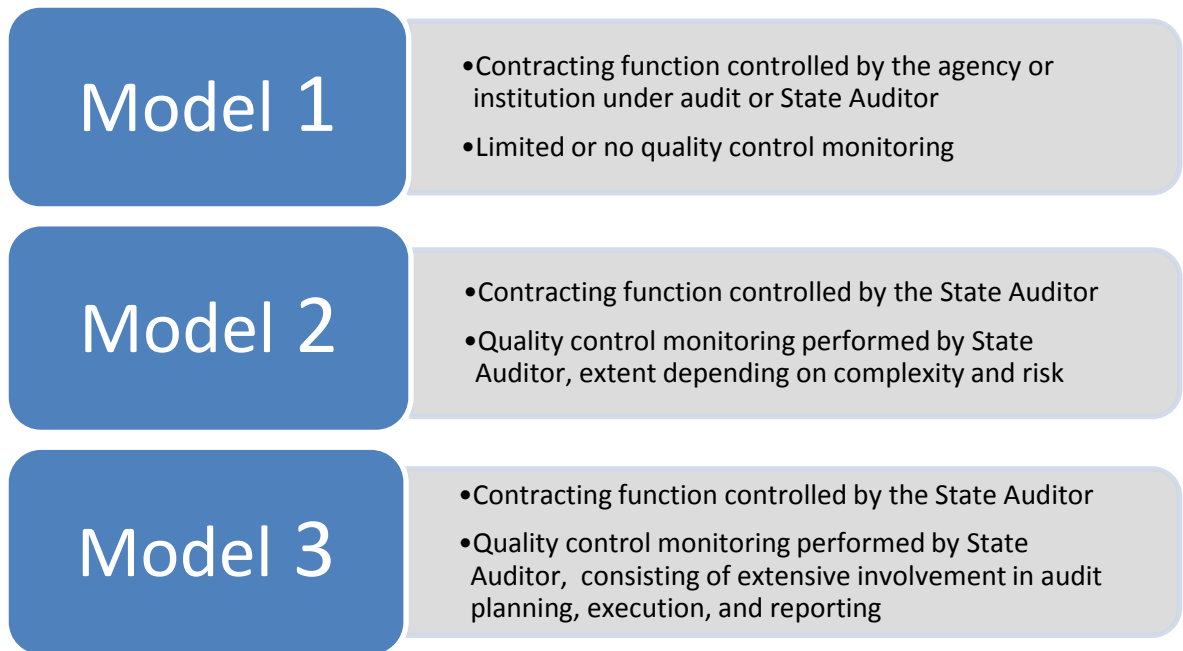
for popular election.

As part of this survey, NASACT gathers data on whether states utilize auditing firms to perform the Comprehensive Annual Financial Report (CAFR) audit or Single Audit, which is the audit of federal programs. Based on the survey results, state auditor offices perform both the CAFR and Single Audits in 21 states, with minimal use of auditing firms (less than 15 percent), primarily for entities outside of the primary government which produce stand-alone financial statements. In ten states, auditing firms perform both the CAFR and Single Audits. In the remaining 18 states, auditing firms perform a portion of either the Single Audit or CAFR Audit as shown below.

Extent of Partial Outsourcing	Number of States
Audit firm conducts between 20% and 50% of Single Audit	9
Audit firm conducts between 51% and 67% of Single Audit	4
Audit Firm conducts 100% of Single Audit	3
Audit Firm conducts portion of CAFR Audit (% not stated in survey)	2

To gather information to assist the legislature in evaluating opportunities for utilizing firms to perform audits and respond to the items included in the letter requesting this study, we interviewed ten states to obtain additional information about the extent of their outsourcing, contracting process, and governance models for managing contracts with auditing firms. Exhibit 2 contains additional information regarding the nature of the states we selected.

We selected states utilizing varying degrees of outsourcing to ensure we covered the various scenarios the Commonwealth could employ. However, we focused more heavily on entities utilizing auditing firms for a substantial portion of their audits. Through our interviews, we noted three models that states are using to govern the outsourcing process, with some variation among models in the individual states.



Model 1

Under Model 1, either the State Auditor or the agency being audited contract for the independent audit firm, but they generally do not perform quality control monitoring of the auditing firm's work other than reviewing the firm's external peer review and the audit report for any obvious deficiencies. In some of the cases where the State Auditor performs the contracting function, when reviewing proposals from firms during the contracting process, they perform some analysis of audit quality. However, this review is fairly limited and only indirectly provides assurance related to audit quality. State Auditors use this model in situations involving extensive outsourcing, as well as those involving limited outsourcing.

The primary benefit of this model is that it appears to incur the least costs in terms of the contract oversight function. One risk associated with this model is there are limited assurances about audit quality beyond the firm's external peer review, which would not necessarily involve the review of Commonwealth of Virginia engagements. In addition, by not performing some level of review of the audit work, the State Auditor does not gain any knowledge of the activities, including internal controls and processes in place, at the agency under audit. This limits the State Auditor's ability to be responsive to legislative requests for information. Finally, if the audited agency does the contracting, there is a loss of legislative oversight and direction under this model. We noted that several of the states using this model are currently strengthening their quality control monitoring process due to concerns about audit quality.

Model 2

Under Model 2, the State Auditor contracts with auditing firms to conduct audits and performs quality control monitoring on all audits; however, the extent of the review depends on the complexity and risk associated with the audit. For some outsourced audits, the State Auditor may provide audit programs and review the work the firm performs prior to report issuance. For others,

the State Auditor may attend key meetings, review the report, and perform a post issuance review of the audit work. State Auditors use this model in situations involving extensive outsourcing, as well as those involving partial outsourcing. One state using this model periodically assigns its staff to work along with the firm on outsourced audits to help maintain knowledge of the entities, which allows for more informed contract monitoring.

There are several benefits associated with this model including providing more assurance surrounding audit quality. In addition, by allowing flexibility regarding the extent of monitoring, the State Auditor can focus staffing resources on more complex and risky audits, which can help control costs associated with monitoring. Another benefit of this model is the State Auditor remains somewhat knowledgeable of the activities of the entities they no longer audit. The primary downside to this model is that it is more costly than Model 1 in terms of the staff necessary to perform the monitoring.

Model 3

Under Model 3, the State Auditor contracts with auditing firms to conduct audits and performs extensive quality control monitoring on all audits, including reviewing and approving the firm's proposed audit procedures prior to the firm performing the work, performing a detailed review of working papers, attending key meetings, and reviewing reports prior to the firm issuing the report. The State Auditor using this model outsources extensively, but is able to assume responsibility for the outsourced audits as opposed to making reference to the work of the firm in their audit opinion because of the high level of involvement in the audits. For example, the State Auditor may spend up to 450 hours performing contract monitoring for one audit due to their involvement in virtually every phase of the audit.

The primary benefits of this model are similar to Model 2 in that it provides significant assurance surrounding audit quality and enables the State Auditor to maintain extensive knowledge of the agencies under audit by the firm. The primary drawback of this model is that it is very costly due to the staffing levels needed to conduct such extensive oversight.

Now that we have provided an overview of the current activities of the Auditor of Public Accounts and models used by other states, we will focus the remainder of this report addressing the issues in the study request letter.

Legislative Oversight Contracting

Independence of the auditor is paramount to ensuring that the audits provide unbiased information, as well as a basic requirement of auditing standards. Independence is achievable under the standards whether the legislature appoints an auditor, as it does currently, or hires an auditing firm. The private sector uses this model by assigning an audit committee, which reports to the Board of Directors and is independent from management, the responsibility for contracting for audits. By keeping the responsibility of the audit process within the legislative branch, when hiring an auditing firm, the legislature becomes the client, not the entity under audit, which will help prevent potential conflicts of interest. Currently, only entities with separate, supervisory boards have audit

committees. If other agencies hired auditors, they are not currently set up with the proper oversight body to ensure the auditors are independent from management.

The NASACT survey data shows there is an even split of responsibility for hiring the audit firm between the legislative and executive branch. Through our interviews, we noted that in some cases where the entity contracts for the audit (Model 1), the State Auditor requires the entity to include certain provisions in the contract to ensure audit quality, adherence to applicable standards and deadlines, and promote continued communication between the State Auditor and auditing firm on significant matters. While this may help mitigate some of the risk, we believe the process outlined in Model 2 above is the stronger model for governance over the audit process. State Auditors currently using this Model feel they are able to use their extensive knowledge of government auditing in evaluating audit proposals and the qualifications of the firms. This knowledge is also vital to sufficient contract monitoring in the form of quality control reviews.

As noted in the APA Overview Section above, the APA currently performs quality control reviews over auditing firms that perform the audits of the Commonwealth's Local Governments. Through our reviews, we sometimes have noted audit quality issues with local, regional, and national firms, ranging from lack of documentation to failure to perform required audit procedures. If we have findings, we report them to the firm and the applicable local government, and depending on the severity of the findings will consider referral to state or federal grantor agencies and/or the Board of Accountancy. In cases of severe findings, we include the auditing firm in our sample the following year to ensure the firm has remediated the prior year findings. In addition, these reviews help us to identify common issues and provide guidance to all firms to ensure these issues are addressed in future audits. Therefore, we believe the quality control monitoring process is an important element in meeting our accountability goals.

Decision Consideration

Legislative oversight of the audit process helps to mitigate some of the risks associated with outsourcing the audit function. In addition, many agencies do not currently have an audit committee or other mechanism to provide separation of the hiring of the auditor from management. Therefore, if the legislature decides to hire audit firms to perform audits of agencies and institutions handling state funds, the legislature should consider retaining its responsibility for audit oversight.

If audit firms are used, we recommend the General Assembly use Model 2 as a governance structure with the State Auditor overseeing the contracting process including hiring the firm and performing quality assurance monitoring over the firm's work. We believe this Model allows for economies of scale relating to the contracting function, best promotes accountability and independence, and helps ensure audit quality.

Decision Point 2

In any cases where the General Assembly decides to hire audit firms, it will need to determine whether it wants to retain legislative oversight of the process.

- A. If the General Assembly decides to retain legislative oversight, which model do they want to use as a governance structure?
- B. If the General Assembly decides not to retain legislative oversight, does it want to require agencies to establish a mechanism to separate hiring of the auditor from agency management?

Outsourcing Alternatives

Financial Statement Audits and Agency Financial Reviews

As we indicated above, the APA performs a variety of audits including stand-alone financial statement audits, audits of agencies that are significant to the CAFR, and audits of agencies that are significant to the Single Audit of federal programs, all these audits use the AICPA auditing standards and the Government Auditing Standards for financial statement audits. Most of the states we interviewed required audit firms to follow both AICPA and Government Auditing Standards when performing financial statement audits. We also perform various types of agency financial reviews using under Government Auditing Standards for performance audits and agreed-upon procedures engagement under AICPA attestation standards.

There are several possible alternatives for approaching outsourcing of audits to audit firms. The **first alternative** considers the CAFR and Single audits. As we have previously discussed, some states do use firms to perform their CAFR and Single Audits. Normally if the state outsources these audits at the state level, national firms or large regional firms perform these audits.

Because of the importance of the CAFR and Single Audits in securing bond and federal funding, the degree of coordination necessary to perform those audits, and the knowledge of government auditing that is vital for those audits, 80 percent of the states have chosen to have their State Auditor's Office either fully or partially perform these audits.

However, there are some unique challenges present in those audits because of the coordination required among different agencies and auditing firms, the decentralized operating environment, and internal control structure at the various agencies.

Because the APA currently audits the majority of the Commonwealth's agencies and institutions, the effort for coordination is significantly less than it would be if multiple auditing firms were involved.

The **second alternative** is associated with stand-alone financial statement audits. Stand-alone financial statement audits, especially those that are components of the Commonwealth, such as the higher education institutions and authorities, are easier to outsource because of the accounting standards governing these entities, the entity's centralized operating environment and internal control structure, and their separate governing body.

In the states that we interviewed, nine of the ten were using auditing firms to either partially or fully audit their higher education institutions.

In the states that we interviewed, six out of the ten used auditing firms for at least some of their enterprise entities and eight out of the ten used auditing firms to audit some of their fiduciary activities.

Enterprise activities, such as the Lottery and Virginia College Savings Plan, and fiduciary activity, such as the Virginia Retirement System also fall into the category of stand-alone financial statements, but are within the primary government. In the Commonwealth, only some of our enterprise activities produce stand-alone financial statements.

Another alternative deals with agency financial reviews. For agencies that do not prepare financial statements, the APA conducts audits using performance auditing standards under Government Auditing Standards. We select agencies for audit based on a variety of factors including risk and date of last audit and at a minimum audit each agency at least once every three years. If the legislature used audit firms for these audits, the General Assembly would have to establish the overall objectives and a methodology for selecting agencies for audit.

Decision Consideration

The Code of Virginia currently allows, but does not require, the APA to hire auditing firms to assist in performing audits of state agencies and institutions. Hiring multiple firms to perform audits of the Commonwealth's agencies and institutions would require additional coordination efforts under new auditing standards that become effective for fiscal year 2013, as the firm with responsibility for the CAFR and Statewide Single Audit would have to collaborate with the firms performing the audits of component units or other agencies that comprise the general government. This could lead to increased costs for the CAFR and single audit. Currently, because the APA does essentially all of this work, the coordination required is minimal.

Currently, the APA issues a separate agency report or Secretarial reports for each agency we audit in support of the CAFR or Single Audit. In those reports we provide budgetary and actual financial data, as well as, information about the operations of those agencies. The auditing firms would provide a single report for the CAFR and Single audits indicating internal control deficiencies they noted in their audit procedures. If the legislature would like to continue to receive agency specific information, they would need to either include a provision in the contract for separate reports, which would likely result in an increase in cost, or alternatively could request the State Comptroller or the Department of Planning and Budget to provide budgetary and actual financial data.

Most of the states we interviewed have the State Auditor continue to conduct agency, financial reviews, performance audits and/or compliance audits at the agency level. Only a couple of states used firms to perform reviews under the AICPA attestation standards for agencies that do not issue financial statements. In those cases, the State Auditor's Office had extensive oversight over these reviews including planning and reviewing the results of the audit firms work.

Other states also use audit firms only on a limited basis for agreed-upon procedures engagements. Although we did note that when states outsourced their higher education institution audits, they also outsourced agreed-upon procedure work related to those institutions.

If the General Assembly wants to hire audit firms, when there is not a requirement to follow both AICPA and Government Auditing Standards, the General Assembly would need to decide what standards firms should follow. For example, for stand-alone financial statements of agencies that do not receive federal funds and for agreed-upon procedures engagements auditors could follow Government Auditing Standards in addition to the required AICPA standards. For agency financial reviews, auditors could follow Government Auditing Standards or AICPA attestation standards.

Decision Point 3

Does the General Assembly want to hire audit firms for any or all of the following:

- the CAFR and Single Audit?
- the stand-alone financial statement audits for colleges and institutions as well as enterprise activities and pensions?
- agreed-upon procedures engagements related to stand-alone financial statement audits?, and/or
- agency financial reviews?

Other Activities

As explained above, the APA performs other activities where we follow internally developed policies and procedures. This work includes audits of the records at the circuit and district courts, other constitutional officers, and general receivers; several Code of Virginia or Appropriation Act mandated activities, including maintenance of Commonwealth Data Point; analysis of budget information and oversight of audit firms that audit local governments. We also receive notification of alleged fraudulent transactions and ensure appropriate review. Some of these activities are part of audits that we perform and others are stand-alone projects. Other State Auditor's Offices generally do not outsource these functions.

Decision Consideration

The APA could include additional requirements for the firms to perform procedures to audit the records at circuit courts and other constitutional officers in the guidelines, or specifications, that CPA firms must follow when auditing local governments. If the auditing firms included this work

with the audit of the locality, it would shift the cost from the state to the localities and the localities would most likely consider this shift of responsibilities an unfunded mandate.

Since general receivers are separately appointed and not a part of the locality, they will continue to need to be audited separately. Further, district courts are a part of the Supreme Court of Virginia and our approach has been to consider that to be one system so we plan that audit at the state level rather than at the locality level. This approach would lend itself to being one separate audit rather than procedures added to the guidelines for multiple firms to perform.

If the General Assembly wants to hire audit firms, when there is not a requirement to follow either AICPA and Government Auditing Standards, the General Assembly would need to determine whether firms should follow standards or alternatively, establish agreed-upon procedures for the firms to follow.

Commonwealth Data Point has quarterly updates with data APA obtains from agencies, and as needed with other sources of data. The APA obtains and validates this data in conjunction with obtaining the data for its audits. If the APA is no longer performing the audits, obtaining the data for Commonwealth Data Point would be a duplication of work done by the auditing firms. In addition, citizens often inquire about information on Data Point and the APA will research as necessary to be responsive to the citizens. While there is no regularity to this work, it is important that we address it timely when the need arises. Our ability to respond could be impacted if the APA no longer performed the audits.

Decision Points 4 through 6

4. Does the General Assembly want to have audit firms perform judicial and constitutional officer audit work?
5. Does the General Assembly want to contract with an audit firm to maintain Commonwealth Data Point?
6. Does the General Assembly want the APA to continue to receive notification of fraudulent transactions and coordinate follow-up reviews?

Benefits and Risks of Outsourcing the Audit Function

During our interviews with other states, we questioned them on the risks and benefits of using auditing firms to perform government audits noting similarities in their responses. Generally, states utilizing audit firms do recognize benefits related to using firms; however, they also identified risks that may outweigh the benefits, if the process is not properly managed by strong contract monitoring.

Risks

The APA has established as its mission that we serve Virginia citizens and decision-makers by providing unbiased, accurate information and sound recommendations to improve accountability and financial management of public funds. This is a broader objective than simply doing financial statement or performance audits. Other State Audit Offices have missions similar to the APA and focus on accountability to the taxpayer. Therefore, State Auditor Offices, including the APA, often perform work in areas beyond what the standards require. Unless the government contracts for additional procedures, firms perform the level of audit work that meets the standards.

For financial statement audits, firms often perform limited internal control testing when allowed by the standards. The auditing standards permit this approach, except when performing work that supports the Single Audit. However, in a government environment, the testing of internal controls is one critical way to ensure proper accountability for and safeguarding of public resources. Therefore, the APA often tests controls even when not required by the auditing standards. We also perform procedures that allow us to make recommendations for improving agency operations to gain efficiencies, which is beyond the scope of a financial statement audit.

State Auditors only perform government audits and therefore have extensive knowledge of government auditing, issues impacting governments, and how their state government operates. There are also national organizations such as NASACT, which promote communication and sharing of information among government auditors, comptrollers, and treasurers, which provides additional perspective on the government environment. The APA is active in the National State Auditors Association, which is a subgroup of NASACT, and has membership on various committees in the organization. This allows the APA to stay current on what is happening in other states and use that information when assessing risk and identifying potential areas to focus on during audits.

Some of the auditing firms, especially national and large regional firms, also have staff that specialize in government audits. However, the depth of knowledge may vary depending on the extent of the firm's government practice, which can impact audit quality. In June of 2007, the President's Council on Integrity and Efficiency (PCIE) released its report on the National Single Audit Sampling Project. The goals of this project were to determine the quality of single audits and recommend procedures to improve the quality of single audits. The PCIE reported that 93 percent of the 14 government auditors' audits sampled provided reports that were reliable. However, only 52 percent of the 193 auditing firms' reports were reliable, 16 percent provided limited reliability, and the remaining 32 percent were unacceptable. As a result of this report, the AICPA has provided additional resources to auditing firms performing governmental audits and made enhancements to related AICPA standards and other guidance to help improve single audit quality.

Several of the states we interviewed had experienced issues with audit quality even to the extent that they required the firms to correct and reissue audit reports. For example, the federal cognizant agency of one state rejected its Single Audit because of deficiencies in the audit process. To help mitigate this risk, states utilize quality control monitoring programs and ensure during the contracting process that the firm has proposed using staff with the appropriate level of government expertise.

Benefits

The primary benefits states noted with using audit firms to perform audits related to staffing including helping to manage staffing shortages and geographic challenges associated with performing audits across the state. In addition, states indicated that they often use audit firms to perform audits requiring specific technical expertise such as actuarial or investing, where it may be difficult to maintain internal staff with that expertise.

Further, they indicated that when using large firms, they benefited from the technical support often provided by “national” offices. An auditing firm also may provide a “fresh” look at the entity under audit with a view from outside of government.

A final benefit reported by using audit firms is that it allows them to divert resources to special projects and investigations in other areas of government such as efficiency and operational audits and be more responsive to issues that may arise such as reports of potential fraud or other inquiries.

Impact of Additional Services on Audit Firm Independence

Auditing firms often look for the opportunity to provide extra non-audit services to its clients such as consulting, operational reviews, and systems development services. Government Auditing Standards provide guidance on when this would compromise an auditor’s independence. Both auditing firms and State Auditors must follow the independence requirements in Government Auditing Standards.

All of the states we interviewed include clauses in their contracts requiring firms to maintain their independence under the applicable auditing standards. Some states require firms to certify their independence. Several states prohibited firms from providing non-audit services, while others required prior approval of the State Auditor’s Office for any additional services. Some states indicated they have experienced problems with firms performing services that impair their independence.

Decision Consideration

We recommend including a clause in all contracts for auditing services requiring firms to maintain their independence in accordance with applicable auditing standards and requiring firms to obtain prior approval of any proposed non-audit services from the appropriate contract oversight entity.

Decision Point 7

Does the General Assembly want to have oversight over non-audit services firms provide to the agencies to ensure the firms are following independence requirements related to non-audit services?

Availability of Firms and Transition of Work

Many of the audits performed by the APA have deadlines. The audit of the Commonwealth's CAFR has a Code of Virginia mandated deadline of December 15th. As a result, completing the audits of larger agencies needs to occur before the CAFR deadline. The agreed-upon procedures engagements related to the NCAA guidelines have a deadline of January 15th. Because many of the universities close for almost two weeks at the end of December, the auditor must complete field work by December 15th in order to ensure the timely issuance of reports. The Comparative Report has a statutorily required issuance date of February 1st and the localities submit the data by November 30th. Therefore, all of the work to review and compile the data must occur in essentially a two month window.

Often the General Assembly will require the APA to study a certain topic and when this occurs, APA must usually issue the report by December 1st so the information is available for consideration in the subsequent General Assembly session. APA's remaining work load occurs throughout the year.

To gain perspective on the number of firms in Virginia available to perform work the APA currently performs, we requested information from the Virginia Society of Certified Public Accountants, which worked with the AICPA to obtain this information. The AICPA accumulates information on firms' practice areas based on data that firms provide through the peer review program. We requested information on firms practicing in areas that relate to the audits we currently perform as detailed below. As of October 2012, 130 different active firms with main offices in Virginia selected one or more of these practice areas.

Practice Area	Number of Firms
Audits Under Government Auditing Standards (Excluding Single Audit Act Engagements)	92
Single Audit Act Engagements Under Government Auditing Standards	79
Colleges and Universities	9
Federal Student Financial Assistance Programs	8
Hospitals	2
State and Local Governments	35
Defined Benefit Plans	29

While there are firms in Virginia with government experience, if the legislature decides to hire firms to perform the audits APA currently performs, these firms would have to plan ahead for staffing needs and gear up to do the work within the required timeframes. Further, some firms that previously have not performed government audits would need to receive training specifically related to government auditing, which is required under Government Auditing Standards.

States have overcome issues in finding qualified firms in a variety of ways including assigning a more experienced contract monitor to the audit if they have concerns about the firm, asking the firm to correct certain areas such as obtaining training or modifying their proposed staffing levels, or allowing the current firm to continue on the audit past the end of the audit contract due to lack of qualified alternatives.

Half of the States Auditors we interviewed, who are responsible for hiring audit firms, indicated they had experienced issues finding firms to perform audits.

Decision Consideration

Should the General Assembly decide to outsource some or all audit services, then the General Assembly will need to make a transition decision. A phased-in approach for transitioning to audit firms would allow firms to add the staffing resources and obtain necessary training related to government auditing. In addition, this would allow sufficient time for the APA to ensure it had sufficient staff and processes in place to perform the contracting and monitoring functions.

Decision Point 8

If the General Assembly decides to hire audit firms, does it want to use a phased in approach or outsource all audits as of a designated date?

Providing Information to the Legislature

Frequently throughout the year, members of the legislative staff contact the APA for perspective on pending issues and accounting matters. Sometimes they want information that is specific to a particular audit that the APA performs, but other times, the requests are more general in nature. Involvement in audits at the agencies allows for the APA to be better prepared to answer the questions that arise.

Some examples of areas that legislative staff has asked APA to provide information to gain additional perspective include unfunded liabilities, restricted cash balances, and long-term debt information. We have engaged in discussions about the proper accounting for leases that might arise out of the refurbishing certain state office buildings. We have provided insights into the accounting implications for new accounting standards on pensions and also on other post-employment benefits. We have provided data to JLARC for their initial review of state spending and for their current review of cost efficiency of Virginia's public universities. Often, the requested information comes from a variety of sources and no one individual or agency has the information.

In our interviews of other states, we found that State Auditor's Office are still able to provide information to the legislature *if* they have a strong contract monitoring function or periodically perform some level of agency review such as an internal control and compliance audits. In states where this function is not present, the legislature often obtains information directly from the agencies and institutions, the State Comptroller, or the planning and budget agency.

Decision Consideration

If firms are performing the audits, then the legislature should consider including in the contract a certain amount of time that the firms would make available for responding to legislative inquiries, or at least setting rates of compensation for any time that would be required of the firm. If the legislature wants the APA to continue to maintain the knowledge necessary to respond to legislative inquiries related to agencies that audit firms audit, the APA will need to maintain sufficient staffing levels for a more comprehensive contract monitoring function.

Decision Point 9

If the General Assembly decides to hire auditing firms, does it want the firms to respond to legislative inquiries or does it want the APA to coordinate the gathering of requested information?

Audit Costs and Fiscal Impact to APA

If the legislature decides to outsource all audits the APA currently performs to auditing firms, we estimate the APA would still need approximately 25 positions to fulfill its non-audit responsibilities, including oversight of local government audits and the Comparative Report on Local Governments Revenues and Expenses and maintenance of Commonwealth Data Point. In this estimate, we also assumed the APA would have responsibility for contracting for the audits and therefore included the necessary procurement staff, but did not include staff necessary for more than limited quality control monitoring. This staffing level would require salaries and fringe benefits of approximately \$2.3 million and other administrative expenses of approximately \$425,000. Based on our fiscal year 2013 appropriation of \$10.5 million, this would leave approximately \$8.2 million in funding to hire audit firms to perform the audit work.

The APA recently contracted for several authority audits using regional firms and the discounted billing rates were as follows.

Staff Level	Rate per Hour		
	Firm A	Firm B	Firm C
Partner	\$210.00	\$263 - \$350	
Senior Manager	\$168.75	\$189 - \$252	
Manager	\$142.50	\$175 - \$233	
Senior	\$101.25	\$113 - \$150	
Staff	\$101.25	\$94 - \$125	
Average rate			\$148

Assuming an average billing rate of \$148, the cost of using audit firms to perform APA's entire work plan of 125,000 hours could be as high as \$18.5 million, which is more than double the funds that would be available without increasing the APA appropriation. For any work not contracted out, the APA would have to increase its staffing from the 25 positions specified above, which would increase our costs and decrease the amount available for paying audit firms.

Below is estimated cost information on several stand-alone financial statement audits the APA performs. The APA tracks staff hours and calculates a billing rate associated with all of our staff. We track this information in our internal time tracking system as we bill for some of our audits. The APA's average billing rate for fiscal year 2012 was \$74. To calculate the cost for firms, we used the hours from our most recently issued audit and the average billing rate of \$148.

These rates are based on available data from only three contracted audits and could vary depending on the size and nature of the audit. Further, we assumed that the time required and scope of work would remain the same for purposes of comparison. It is important to note that as previously discussed, the APA often expands its scope beyond that required by the accounting standards. Unless specifically required to do so by the legislature, the auditing firm may not perform additional procedures beyond those required by the standards, which could reduce its costs. The APA could also restrict its audit procedures to those required by the standards and reduce its audit costs as well.

Audit	Hours	APA Cost	Calculated Firm Cost
Lottery	1588	\$120,944	\$234,950
University of Virginia (including the Medical Center)	5208	\$341,719	\$770,784
Virginia College Savings Plan	1172	\$81,863	\$173,456
Virginia Economic Development Partnership Authority	409	\$28,526	\$60,458
Virginia Retirement System	2173	\$147,224	\$321,530
Virginia Polytechnic Institute and State University	3426	\$256,025	\$507,048

In our interviews, most states indicated that the rates varied depending on the size, risk, and complexity associated with the audit. Most states use fixed rate pricing for the contracts, but allow audit firms to submit requests for contract modifications if they have to perform unexpected work or receive requests to provide additional services.

When evaluating proposals, the states do consider the proposed cost, but none of the State Auditors we interviewed that are responsible for hiring audit firms use it as the primary criteria in evaluating proposals. Most states evaluate proposals from firms based on multiple criteria weighted heavily towards technical criteria. Several states cautioned against low bid audits as they indicated that their experience shows a decline in audit quality as firms reduce the extent of their audit procedures to achieve profit margins for these audits. Therefore, it is not a given that cost savings will occur when outsourcing audits.

Decision Consideration

There is the potential for audit costs to increase beyond the APA's current budget if the General Assembly wants to use audit firms while maintaining the same scope of audits and other services the APA has historically provided. If the General Assembly decides to hire audit firms and keep funding levels the same, it will need to prioritize which audits and services it wants to retain.

Decision Point 10

Does the General Assembly want the budgetary impact of the decision to outsource to remain cost neutral or will they direct more resources towards audit costs to continue the current level of reliance?

Conclusion

Prior to addressing the *decision points* we have outlined in this report, the General Assembly should consider determining what its overall objective is for using auditing firms instead of the APA to perform audits. Having the objective in mind would help to provide a context for considering the various *decision points*, as some may not be relevant, depending on the objective. In addition, due to interdependencies between the *decisions points*, the General Assembly should not attempt to address them singularly; but should consider each in relation to the other *decision points*.

Appendix A

Crosswalk Between Requested Information, Report Sections and Decision Points

Should the Legislature retain oversight over the audit function?

Discussed in sections titled:

Legislative Oversight
Legislative Oversight Contracting

Related Decision Points:

Decision Point 1

What extent of internal expertise does the General Assembly want to have available to advise them of financial risk areas at agencies and on accounting and auditing requirements and the impact of these requirements on the Commonwealth?

Decision Point 2

In any cases where the General Assembly decides to hire audit firms, it will need to determine whether it wants to retain legislative oversight of the process.

- A. If the General Assembly decides to retain legislative oversight, which model do they want to use as a governance structure?
- B. If the General Assembly decides not to retain legislative oversight, does it want to require agencies to establish a mechanism to separate hiring of the auditor from agency management?

What audits could an audit firm perform and what auditing standards should firms follow when performing this work?

Discussed in section titled:

Outsourcing Alternatives

Related Decision Points:

Decision Points 3

Does the General Assembly want to hire audit firms for any or all of the following:

- the CAFR and Single Audit?
- the stand-alone financial statement audits for colleges and institutions as well as enterprise activities and pensions?
- agreed-upon procedures engagements related to stand-alone financial statement audits?, and/or
- agency financial reviews?

Decision Point 4

Does the General Assembly want to have audit firms perform judicial and constitutional officer audit work?

Decision Point 5

Does the General Assembly want to contract with an audit firm to maintain Commonwealth Data Point?

Decision Point 6

Does the General Assembly want the APA to continue to receive notification of fraudulent transactions and coordinate follow-up reviews?

What are the benefits and risk to the Executive branch when working with an audit firm?

Discussed in section titled:

Benefits and Risks of Outsourcing the Audit Function

Due to deadlines associated with some of the audits, are there firms with sufficient staff available to perform the work within required timeframes? Should the Commonwealth consider a transition period to ensure firms have sufficient staff?

Discussed in section titled:

Availability of Firms and Transition of Work

Related Decision Points:

Decision Point 8

If the General Assembly decides to hire audit firms, does it want to use a phased in approach or outsource all audits as of a designated date?

What is the extent of outsourcing in other states and the associated costs?

Discussed in sections titled:

Models Used by Other States

Outsourcing Alternatives

Audit Costs and Fiscal Impact to APA

How could audit firms recover the costs of information requested by the legislature beyond the audit service?

Discussed in section titled:

Providing Information to the Legislature

Related Decision Points:

Decision Point 9

If the General Assembly decides to hire auditing firms, does it want the firms to respond to legislative inquiries or does it want the APA to coordinate the gathering of requested information?

Can audit firms provide other services to the Commonwealth's agencies and institutions beyond the audit contract?

Discussed in section titled:

Impact of Additional Services on Audit Firm Independence

Related Decision Points:

Decision Point 7

Does the General Assembly want to have oversight over non-audit services firms provide to the agencies to ensure the firms are following independence requirements related to non-audit services?

What is the fiscal impact to the APA of making this change?

Discussed in section titled:

Audit Costs and Fiscal Impact to APA

Related Decision Points:

Decision Point 10

Does the General Assembly want the budgetary impact of the decision to outsource to remain cost neutral or will they direct more resources towards audit costs to continue the current level of reliance?



COMMONWEALTH OF VIRGINIA
HOUSE OF DELEGATES
RICHMOND

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POST OFFICE BOX 70365
RICHMOND, VIRGINIA 23255-0365

SEVENTY-THIRD DISTRICT

COMMITTEE ASSIGNMENTS:
HEALTH, WELFARE AND INSTITUTIONS (VICE CHAIRMAN)
PRIVILEGES AND ELECTIONS
APPROPRIATIONS

January 31, 2012

Mr. Walter J. Kucharski
Auditor of Public Accounts
P.O. Box 1295
Richmond, VA 23218

Dear Mr. Kucharski,

In accordance with Section 30-133F of the Code of Virginia, we are requesting technical assistance from your office regarding information about the potential to use Certified Public Accounting (CPA) firms to do audits currently conducted by Auditor of Public Accounts (APA) staff.

We would like you to consider the following issues and provide us with a report that will assist us in determining the merits of the above proposal. We would also request that you consider the public stakeholders in this matter, such as the Virginia Society of Certified Public Accountants.

1. Should the Legislature retain oversight of the audit function?
2. What audits could a CPA firm perform, considering not all agencies and institutions of the Commonwealth prepare separate financial statements since they are part of the Commonwealth's annual financial report and separate statements would increase overall cost to the agency and institution as well as the Commonwealth? If a CPA firm did audit agencies and institutions, what work should they perform?
3. What are the costs, benefits, and risk to the Executive branch when working with a CPA firm?
4. Due to deadlines in the Code of Virginia for the Commonwealth's Comprehensive Annual Financial Report and certain agencies as well as deadlines in bond covenants, are there CPA firms with sufficient staff available to do the work currently in the required timeframes? If there is a change to require CPA firms, should the Commonwealth consider a transition period for the work to meet resources?
5. What do other states do? Information about the extent of their outsourcing and the costs would be helpful to us.
6. Your staff has historically provided information to General Assembly members and their and committee staffs, based on the work performed during audits. If this a service that the Legislature wishes to continue how would CPA firms recover their costs?
7. If CPA firms audit Commonwealth agencies and institutions, could they provide those agencies and institutions other services beyond the audit contract? Should all audits conform to generally accepted government auditing standards?
8. What is the fiscal impact to your office of making this change? Are there other impacts to your office that we should be aware of?

We would like to receive this information in time to consider legislation during the 2013 session of the General Assembly and would expect a briefing to General Government Subcommittee of the House Appropriations Committee. We appreciate you looking into these issues for us and look forward to any information you can provide.

Sincerely,

Tony O. Wilt
Delegate, 26th District

John M. O'Bannon, III, Chairman
General Government Subcommittee
of the House Appropriations Committee

Exhibit 2
States Interviewed by APA

State	Is State Auditor Appointed or Elected?	Governance Model	Who contracts for audit?	Audits Outsourced					Other Relevant Information
				CAFR	SSA	Higher Education	Pension System	Enterprise Activity	
Arizona	Appointed	Model 1	State Auditor	No	No	Community Colleges only	No	No	
Colorado	Appointed	Model 2	State Auditor	Partial	Partial	Yes	Yes	Yes	State Auditor outsources all entities that issue stand-alone financial statements. Also, audit firms provide assistance with CAFR and SSA, but the work is directed by the State Auditor's Office.
Delaware	Elected	Model 2	State Auditor	Yes	Yes	Yes	Yes	Yes	State Auditor periodically assigns their staff work on outsourced audits to allow for better contract monitoring. State Auditor has right of first refusal for all audits.
Georgia	Appointed	Model 1	Executive	No	Partial	No	Yes	No	Agencies contract for audits of entities for which the State Auditor is not independent. The State Auditor serves on the Boards of various Executive branch entities.
Illinois	Appointed	Model 3	State Auditor	Partial	Yes	Yes	Yes	Yes	State Auditor has extensive oversight over outsourced audits, which allows him to take responsibility for this work when issuing the opinion on the CAFR.
Kansas	Appointed	Model 1	State Auditor	Yes	Yes	Yes	Yes	Yes	
Kentucky	Elected	Model 1	Executive	Partial	No	Yes	Yes	Yes	There are a limited number of entities within the primary government not audited by the State Auditor. State Auditor has right of first refusal for all audits.
Maryland	Appointed	Model 2	Executive	Yes	Yes	Yes	Yes	Yes	The Comptroller's office contracts for all financial statement audits.
North Carolina	Elected	Model 1	Executive	No	No	Community Colleges only	No	No	North Carolina recently passed legislation allowing Community Colleges to hire audit firms to perform audits.
Ohio	Elected	Model 2	State Auditor	No	No	Yes	Yes	No	

Commonwealth of Virginia

Auditor of Public Accounts

Walter J. Kucharski
Auditor of Public Accounts

P.O. Box 1295
Richmond, Virginia 23218

December 12, 2012

The Honorable John M. O'Bannon III
Chairman, Joint Legislative Audit
and Review Commission
Chairman, General Government Subcommittee
of the House Appropriations Committee

The Honorable Tony O. Wilt
Delegate, 26th District

We have completed our review of potential considerations in procuring the services of auditing firms and submit our report entitled, **"Study on Feasibility of Using CPA Firms"** for your review.

In the 2012 Session of the General Assembly, House Bill 341 proposed that the Auditor of Public Accounts procure the services of auditing firms to carry out the duty to audit the accounts of state agencies and institutions, or other agency handling any state funds, subject to the provision that the cost should not exceed funds available in the appropriation for the conduct of the office. The Chairman of the General Government Subcommittee of the House Appropriations Committee requested, with the concurrence of the Bill's patron, that the APA review certain issues surrounding the proposal and consult with public stakeholders and report back to the General Government Subcommittee prior to the beginning of the 2013 session of the General Assembly. This report includes various decision points for consideration by the General Assembly.

We met with representatives from the Virginia Society of Certified Public Accountants (VSCPA) during the planning process to discuss our study approach and areas where the VSCPA could provide assistance. The VSCPA provided information included in the *Availability of Firms and Transition of Work* section of the report. We provided a draft of the report to the VSCPA for review and they created a task force of CPAs to review and provide comments on the report. We then met with the VSCPA to discuss their comments, and provided a revised draft for further review and have considered their comments when making changes to this final report.

AUDITOR OF PUBLIC ACCOUNTS